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PLEASE PASS TO USTR - MICHAEL BEEMAN

E.O. 12958: N/A
TAGS: ECON ENRG JA
SUBJECT: SAKHALIN I PROJECT PROCEEDING BUT LACKS BUYERS

1) (SBU) A senior businessman from ExxonMobil reported that the Sakhalin I project was going well but that Japanese gas and electric companies remain uninterested in purchasing gas via pipeline, preferring instead to receive it in the form of liquid natural gas (LNG) via ship . As a result Exxon has turned its sights on China for buyers but has thus far not reached a deal. The businessman dismissed press speculation that Exxon would turn to Shell and Sakhalin II to liquefy the gas produced at Sakhalin I. He also noted the growing importance of Russia versus the South China Sea and added that the Russian central government had little influence on Sakhalin. END SUMMARY

2) In mid-January EMIN met with a senior businessman from ExxonMobil to discuss the ongoing Sakhalin I project off the eastern coast of Russia, of which ExxonMobil owns 30%. Russia's Rosneft originally owned 40% of the project but has since sold 20% to Oil and Natural Gas Corporation (ONGC) India as a "carry", i.e. Rosneft loaned ONGC the money to make the purchase and is being paid back from profits on the deal, a fairly common arrangement in the oil and gas business. The Sakhalin Oil and Gas Company (SODECO), a Japanese consortium comprised of Itochu, Marubeni and Japan Petroleum and Exploration Company (JAPEX), owns the other 50%. The businessman further explained that SODECO had been 50% owned by the Japan National Oil Corporation (JNOC), but after JNOC was dissolved in 2005, its portion was taken over and is managed by the Ministry for Economy, Trade and Industry (METI).

3) Due to its expertise, ExxonMobil is the Sakhalin project operator, but it shares the project risk among its partners who meet regularly to make decisions. Over the last three years the group has invested $6 billion in the first phase of Sakhalin I, which by the end of 2005 was expected to produce 50,000 barrels of oil per day and 2 million cubic feet of gas -- not huge but not insignificant either. The project expects to pump 250 billion barrels of oil in 2006, eventually rising to 400 billion. Gas production should double to 4 million cubic feet.

4) The sea off the northern coast of Sakhalin is under ice six months of the year. To allow the complex to operate 24/7/365, ExxonMobil has totally enclosed it to the tune of $40 million. By comparison, Shell operates Sakhalin II only six months of the year. The businessman also noted that

salaries are comparatively high for the expatriates and the local hires.

5) Sakhalin's Phase II will cost approximately $5-6 billion to complete, bringing the total cost of the overall project to $10-12 billion. It primarily focuses on natural gas production which ExxonMobil wants to market to Japan. The company is looking to build a 2400 kilometer (1800 miles) pipeline from Sakhalin to Tokyo Bay to bring the gas to Japan. The pipe would run from Sakhalin to Hokkaido, through Sapporo, then back offshore to the Pacific coast, down to Sendai and on to Tokyo. The technology already exists for such an endeavor and the businessman emphasized that neither the pipeline length nor the cost was unreasonable. He dismissed press speculation that ExxonMobil would be forced to turn to Shell's Sakhalin II project to liquefy the gas and ship the LNG to Japan. However, no Japanese company has signed a contract with the company yet to receive gas via the pipeline so Exxon has not begun building it.
6) Due to the lack of Japanese interest, the company is now negotiating with Chinese buyers. The China National Petroleum Corporation (CNPC) signed a letter of intent in October 2004 to have ExxonMobil build a pipeline to the Russian border. This pipeline would run along existing roads and rights-of-way in Russia, according to the businessman. China would buy the gas at the border and then take responsibility for getting it to Harbin and beyond. All of the negotiations are complete except for price. The businessman said ExxonMobil was prepared to walk away from the deal if they could not agree an appropriate price. He thought the Chinese failed to understand this because few Western companies had walked away from deals with China thus far.

7) The businessman bemoaned the fact that Japan had done away with domestic energy market regulators but had left the energy monopsonies in place, which continued to defy the government's efforts to diversify Japanese energy imports. Japan's LNG terminals are wholly owned by the companies but a pipeline is by law an open access vehicle. Once the pipeline is built it cannot be moved and it belongs to the country that builds it -- something he believed the GOJ understood but Japanese energy companies did not. The businessman argued that the government should create separate companies to own and operate the LNG terminals. The GOJ had funded the Sakhalin feasibility studies at a cost of several hundred million dollars and now private industry stood in the way of it seeing any return on that investment in the form of Japanese energy imports from Sakhalin.

8) The businessman noted that METI should concentrate less on South China Sea deposits and more on Russia where there were far greater resources. He estimated that the East China Sea probably had only one-tenth the resources available in Sakhalin. He added that ExxonMobil is largely immune to the machinations of the Russian government.

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